At the same time, Dr. VanderWeide's assessment of cable industry risk and proposed cable industry capital structure is based on the assumption that, at present, competition for some cable operators is limited. But in the long term, cable will be subject to intense and direct competition (apparently from telephone companies, among others). If a long-term capital structure is used, then a long-term risk assesment -- extremely high -- must also be used.

In this regard, the Commission's proposal to use a capital structure composed of 50% debt and 50% equity is quite close to the capital structure at the holding company level of the mature telephone industry. This is, in all likelihood, a far better estimate of the cable industry's long-term capital structure than the arbitrary 86% debt/14% equity radio advocated by Dr. VanderWiede.[20/]

What the telephone companies want is to force the cable industry to live with rules that the telephone companies themselves view and burdensome and outmoded. The proper solution for these concerns, however, is for the telephone companies to

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20/ Dr. VanderWeide admits that his 86/14 proposal is based on ignoring actual cable industry capitalization because it is inconvenient for his analysis to acknowledge the industry's actual accumulated losses. VanderWeide ¶10. The Commission, by contrast, may not lawfully ignore the financial realities facing the cable industry in setting cost of service standards.

seek relief from any truly unreasonable regulatory burdens in the upcoming Price Cap Review, not to arbitrarily impose those rules they don't like on cable television.[21/]

Aside from being unfair and irrational, applying telephone rules wholesale to cable would fly in the face of express Congressional directives to avoid Title II regulation of cable. In their frenzy to burden cable with new regulatory requirements, the telephone companies appear to have forgotten that this proceeding applies to non-premium video entertainment services, not to basic voice telephony.

The fact -- relied on so heavily by the telephone companies -- that cable and telephone share some technologies, like fiber, does not mandate that the same rules must apply to both industries, particularly during this initial, transitional stage of cable regulation. Automobiles and aircraft both use more and more microprocessers, and both can transport a passenger from Washington to New York; but that does not mean that Hertz needs to follow the same safety regulations applied to the Delta Shuttle. Both LECs and IXCs have fiber in their plant, but that does not mean that MCI must be regulated just like NYNEX.

21/ Bell South, with commendable candor, admits as much. See Comments of Bell South at p.3.

It is true that some cable operators are now attempting to compete with telephone companies in a very small fraction -- less than 1% -- of the local exchange market, but that does not mean that regulation of the two industries must be identical. First, the area of overlap is so small that it would be arbitrary and irrational to make it the controlling factor in regulating a cable industry that does not otherwise have similar historical, workforce, financial, or technological characteristics, and which is at a completely different stage of development. Second, as just noted, this proceeding relates to regulation of non-premium video entertainment, not telephony. Third, Congress has specifically instructed the Commission to avoid imposition of Title II rules on cable.

In the specific context of establishing a reasonable rate of return, Continental's risk premium proposal -- unlike that advanced by the telephone companies -- takes full account of the differences between the industries, as measured by objective, verifiable, market driven sources: the relative volatility of cable stocks as compared to telephone stocks; the comparative spread of telephone versus cable debt as compared to risk free treasury bonds; the relative penetration of cable against other household goods and services, including telephone; and lenders' restrictions on cable operations -- which are foreign to any telephone debt issue.

Simply put, the risks of investment in cable television are demonstrably greater than those of investment in telephone, and the rate of return must be set accordingly. That rate of return will be fully consistent with telephone regulatory principles, but tailored to the special, transitional circumstances of the cable industry at this unique point in its history.

Nor is there a basis, in service of some icon of regulatory "parity," for subjecting cable rates to a productivity offset of the sort applied to Tier I LECs under price cap regulation. The LEC productivity offset was derived from a long record of cost-of-service-based rates which demonstrated historic and ongoing economies. Moreover, these economies were reasonably viewed to be at least roughly comparable among Tier I LEC's. For the cable television industry, however, the Commission itself has acknowledged that no such data exist. Indeed, what data there are show that economies in cable are one-time in nature, cannot be predicted to recur as the industry matures, and vary greatly among operators and regions depending on factors such as network density, economies of scale, economies of channel capacity, and other economic and financial characteristics. Moreover, the one indicator that can be measured with reasonable accuracy -- labor productivity for the past eleven years -- shows a productivity factor of zero.[22/]

22/ *See* Continental's August 25 Comments at Exh. D.

The simplistic analysis presented by Bell Atlantic's affiant Robert Townsend should be rejected because it rests on the fundamentally erroneous notion that more channels equals more productivity. Multiplying the number of channels by ten, however, does not lead to a 10-fold increase in subscribers or revenues, nor does it cut costs by a factor of ten. Nor may the Commission blithely assume, as does Mr. Townsend, that fiber and other investments to upgrade the cable industry's portion of the nation's infrastructure will be "essentially self-funding" from operational efficiencies and incremental cash flow. While telephone companies may enjoy the luxury of "self-funding," imposing a stringent productivity offset (or otherwise depriving cable of necessary revenues) could easily eliminate incremental cash flow and put even basic necessary investments at risk.

The telephone companies' true motives for pressing for "parity" are clear from their submissions. They object, for themselves, to the use of a productivity offset and to sharing equity returns with customers, yet they propose to impose the same requirements on cable. Heavy with management employees after a hundred years of regulated monopolies, they seek to handicap an enterprise with far leaner staffing. Forgetful of their own oft-repeated skepticism about the long-term feasibility of predatory pricing, they nonetheless conjure images of cable operators, successfully preying on LECs many times their size in terms of assets and revenues. They claim an interest in regulatory parity, yet propose saddling cable with significant, new, unnecessary regulatory costs -- which are already covered in LEC prices -- while denying cable a means to recover them. Their sole interest, as manifested by their Comments, is in protecting themselves, not the public interest.23/

Morover, even under the LECs' own "parity" analysis, it makes no sense to set cable's rate of return based solely on present market conditions while the LECs continue to reap enormous profits from access services based upon market conditions now four years old. If the LECs were sincere about regulatory parity, they would be endorsing Mr. VanderWeide's 8.85% return for themselves rather than doing their utmost to deny cable anything approaching the 19.5% equity return telephone companies now earn.24/

The Comments of the LECs must be seen for what they are: opportunistic efforts by formidable potential competitors to stifle the cable industry as LECs move into the video services business and cable operators seek to replace lost entertainment

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23/ See, e.g., Bell Atlantic at 11 ("until the Commission is prepared to reconsider its rationale for imposing a productivity offset and sharing obligation on telcos, its price caps for cable should include the same features").

24/ See Martha M. Hamilton, Study Shows High Returns For Utilities, Washington Post, Sept. 10, 1993, B1, B8 (quoting NARUC Study of Bell Atlantic and other utility returns).

revenues with new revenue streams. The Commission should reject this self-serving effort to use its processes to thwart competition in the market, and adopt instead a rate of return factor, based upon risk premium, as suggested by Continental.

V. PROCEDURES AND STREAMLINING

A. The Commission Should Not Defer Cost of Service ("COS") Principles to Case-By-Case Development

Some comments suggest that the development of appropriate cost of service principles should await case-by-case development. Continental submits that, as with any new scheme of regulation, fine tuning will take place in the application of principles to actual facts. This is the case when the Commission, for example, issues guidance to responsible accounting officers at LEC's or clarifies by adjudication the calculation of pole costs of electric utilities. But for any premptive federal scheme of regulation to work when most franchising authorities have little or no experience in cost of service regulation, it is imperative that the Commission resolve the key substantive elements of the rate base, the debt/equity structure, the authorized rate of return, and the allowance of operating and programming expenses. Otherwise, cost of service regulation will fall victim to thousands of franchising authorities who, through inconsistent rate rulings, can thoroughly balkanize and stunt the future growth of the cable industry. Just as the Commission has established clear, preemptive principles of technical standards, it must do so for rate regulation. Continental's detailed proposals for rate regulation are contained in its August 25 Comments.

B. Addressibility Should Be a Benchmark Adjustment

Continental's August 25 Comments include as Exhibit D a study by Economics & Technology, Inc. (ETI) confirming that the FCC's benchmark data set and the statistical regression method employed by the Commission produce a benchmark adjustment for addressable systems which the Commission overlooked in its initial data run. The ETI results are corroborated by an economic study submitted with Time Warner's August 25, 1993 Comments.[25/] The Time Warner results show the same relationship between the percent addressability and the price per channel that ETI shows in its study.[26/] In order to avoid rewriting all of the benchmarks, Continental has proposed a benchmark add-on for systems with addressability. As a statistical matter alone, the

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25/ National Economic Research Associates, "A Proposal for Backstop Regulation For Cable Television Prices", August 25, 1992, Attachment 1.

26/ The Time Warner study shows a value of 0.1001978 for addressability in Attachment 1. Since ETI measures addressability as a percent (e.g., 63.0%) and they use a decimal version (e.g., 0.630), their result comparable to the ETI 0.0009 is their value divided by 100 which equals 0.0010. Thus the Time Warner value is essentially identical to ETI's. Either method produces the same benchmark adjustments shown in the ETI study.

Commission should adopt the addressabiity adjustment. But the adjustment is independently justified on public policy grounds as a means for rewarding cable operators who invest in the technology to promote and maximize customer choice. It would also eliminate the need for full cost of service showings by systems whose investment in that technology has increased their costs above the benchmark prices for nonaddressable systems. For these reasons, we urge the Commission promptly to adopt an addressability adjustment to the benchmark.

C. Continental's Rate Base Proposals Will Have Streamlining Effects

In addition to the standard rate case, the Commission can greatly ease the burden at both federal and local jurisdictions if it adopts the streamlining proposals Continental has outlined. For example, as noted above, by including current and projected CWIP in the rate base, along with adjustments for other known and measurable changes, the Commission will not only facilitate the capital management needed to rebuild cable systems, it will also minimize the number of rate cases, stabilize rates, and eliminate the need for establishing an artificial (e.g. three year) limit on the number of COS filings.

D. <u>Subsequent COS Cases Should Be Permitted With Externals and GNPPI</u>

The Commission should clarify that after the completion of a cost of service showing operators will be permitted to apply GNPPI and the price cap externals to the COS rate in future years. This will facilitate adjustments in rates, based upon costs already ruled reasonable plus costs demonstrated (through external adjustments) to be reasonable.

VI. <u>COS SHOWINGS MUST BE REVIEWED WITHOUT REGARD TO "THRESHOLD" SHOWINGS OF EXCEPTIONALITY</u>

Many franchising authorities have suggested that cost of service showings should not even be entertained unless the cable operator makes a demonstration of exceptional circumstances which distinguish it from benchmark systems. Although it may be administratively attractive to erect a hurdle before COS filings will be reviewed, it would be arbitrary and confiscatory to do so.

In the first place, the Commission has deferred critical questions arising under benchmarks to cost of service showings. The premise of the <u>First Report</u> is that the safety valve of cost of service showings will satisfy the Act's commands to consider overall earnings for all regulated services, and account for capital and operating costs. <u>See</u>, <u>e.g.</u>, <u>Report and Order</u>, at ¶400 n. 976. The <u>Reconsideration</u> and <u>Second Report</u> also defer major, critical issues to COS cases: recovery and for assuming that the data set used to establish benchmarks reflect prices needed to cover curent costs. Indeed, if the Commission's assumption -- that businesses which are operating are presumably making money -- had any validity, then there would never be a restaurant failure, nor a Chapter 11 reorganization.

Even with the most streamlined procedures, cost of service showings will be sufficiently arduous, expensive and time consuming for all parties, so that operators will not lightly seek this relief. Additional administrative barriers serve no useful function and, in fact, fly in the face of the Commission's efforts to streamline cost of service proceedings.

The best evidence of a cable operator's financial condition is its cost of service showing, not how it compares with price benchmarks. If the Commission were to refuse to examine the actual costs of an operator seeking a nonconfiscatory return, if would be doing the gravest injustice. It would ignore the best evidence of cost. It would effect a taking. It would also undermine the constitutional safety valve on which the entire benchmarking scheme is premised: that a cable operator

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[Footnote Continued]

pay higher taxes to continue subsidizing City Cable, the city-owned cable system."); Vincent Pasdeloup, <u>Double Hit in Paragould: Municipal Cable Subscribers Support Service thorugh Rates and a Tax</u>, CableWorld (Apr. 19, 1993); The Zephyrhills (FL0653) overbuild has collapsed since the September 1, 1992 study.

can elect to make a cost of service showing if it is not adequately compensated under the benchmarks or needs to rebuild a system. There comes a point when the mantra of administrative convenience cannot substitute for the constitutional requirements of due process and fair compensation.